Supreme Court, U.S.
FILED
AUG 16 1991
OFFICE OF THE CLERK

No. 90-1905

In the Supreme Court of the United States

OCTOBER TERM, 1991

JAMES B. MARINE AND VERA L. MARINE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General
SHIRLEY D. PETERSON
Assistant Attorney General
DAVID ENGLISH CARMACK
JOAN I. OPPENHEIMER
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTIONS PRESENTED

1. Whether petitioners are entitled to theft loss deductions for tax years that ended before the claimed theft was discovered.

2. Whether petitioners are entitled to deduct depreciation and interest expenses derived from a transaction that lacks economic substance.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	1
Argument	5
Conclusion	10

TABLE OF AUTHORITIES

Cases:

Brannen v. *Commissioner*, 722 F.2d 695 (11th Cir. 1984) 7

Commissioner v. *P.G. Lake, Inc.*, 356 U.S. 260 (1958) 7

Commissioner v. *Tufts*, 461 U.S. 300 (1983) 8

Estate of Franklin v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976) 7

Estate of Isaacson v. *Commissioner*, 860 F.2d 55 (2d Cir. 1988) 7

Gregory v. *Helvering*, 293 U.S. 465 (1935) 7

Lary v. *United States*, 608 F. Supp. 258 (N.D. Ala. 1985), aff'd, 787 F.2d 1538 (11th Cir. 1986) .. 5-6

Neely v. *Commissioner*, 85 T.C. 934 (1985) 9

Odend'hal v. *Commissioner*, 748 F.2d 908 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985) 7

Pleasant Summit Land Corp. v. *Commissioner*, 863 F.2d 263 (3d Cir. 1988), cert. denied, 493 U.S. 901 (1989) 7

Polakof v. *Commissioner*, 820 F.2d 321 (9th Cir. 1987), cert. denied, 484 U.S. 1025 (1988) 7

Rainbow Inn, Inc. v. *Commissioner*, 433 F.2d 640 (3d Cir. 1970) 6

Ramsay Scarlett & Co. v. *Commissioner*, 61 T.C. 795 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975) 6

Cases—Continued: Page

Rod Warren Ink v. *Commissioner*, 912 F.2d 325 (9th Cir. 1990) 6

United States v. *Schulman*, 817 F.2d 1355 (9th Cir. 1987), cert. denied, 111 S. Ct. 51 (1990) 8

Statutes, regulation and rule:

Internal Revenue Code (26 U.S.C.):

§ 165(e) 5

§ 545(b)(4) 6

§ 6621(c) 8, 9

§ 6653(a) 8, 9

§ 6661 ..... 8, 9

Treas. Reg. § 1.165-8(a)(2) 6

Sup. Ct. R. 10.1(a) 6

In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 90-1905

JAMES B. MARINE AND VERA L. MARINE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-3) is not reported, but the decision is noted at 921 F.2d 280 (Table). The opinion of the Tax Court (Pet. App. 4-102) is reported at 92 T.C. 958.

JURISDICTION

The judgment of the court of appeals was entered on January 2, 1991. A petition for rehearing was denied on February 21, 1991 (Pet. App. 0). The petition for a writ of certiorari was filed on May 21, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner James B. Marine (petitioner) contributed $60,000 in 1979 to become a limited partner in Clark,

Ltd. (Pet. App. 7). In 1980, petitioner contributed $36,000 to become a limited partner in Trout, Ltd. (*id.* at 10). Both partnerships were promoted by Gerald L. Schulman (Schulman). The alleged purpose of the partnerships was to acquire real property on which a United States post office was located (*id.* at 7, 10, 12).

Each prospectus characterized the partnership as a "tax shelter" and stated that "all dollars in the one time investment are written off either because they are shielded by depreciation or interest" (Pet. App. 9, 11). Neither prospectus contained an appraisal of the property or a projection of potential appreciation or economic profit (*id.* at 11). Although each prospectus stated that the property was subject to a non-cancellable 20-year lease with the United States, with several five-year renewal options, petitioners did not examine a copy of either lease prior to investing. They thus did not know that the leases gave an option to the United States to purchase the property at prices substantially lower than the prices paid by the partnerships (*id.* at 7, 10-11, 24-25, 29).

The partnerships were designed to generate purported interest deductions in the first year in an amount equal to the investor's cash contribution (Pet. App. 9, 11, 13). The interest was purportedly to be paid on an unsecured short-term loan to the partnership from a foreign corporation. The proceeds of that loan were, in turn, to be lent by the partnership (without security or interest) to a second foreign corporation, whose purported function was to locate properties to be acquired by the partnership and to provide the partnership with long-term financing for such acquisitions (*id.* at 13-14). In fact, however, the partnerships did not obtain such loans or pay interest on them. Instead, the partnerships engaged in circular financial transactions that merely simulated the payment of interest (*id.* at 19).

2. In 1985, Schulman was indicted on 20 counts of conspiracy, making or subscribing a false tax return or

document and aiding in the preparation of a false tax return or document. The charges arose from his promotion and administration of schemes to generate ostensible interest deductions for various partnerships by circular financing (Pet. App. 34). On February 12, 1988, Schulman was convicted on all 20 counts (*id.* at 35).

Clark, Ltd., and Trout, Ltd., reported substantial losses on their partnership returns due to their deductions for depreciation, interest, insurance, and maintenance (Pet. App. 41-42). On their jointly filed 1979, 1980, 1981, and 1982 tax returns, petitioners deducted $63,664, $14,252, $13,733, and $13,676, respectively, as their proportionate shares of Clark's losses. On their 1980, 1981, and 1982 tax returns, they deducted $38,783, $8,428, and $8,404, respectively, as their proportionate share of Trout's losses (*id.* at 42-43). The Commissioner disallowed these deductions and asserted deficiences. Petitioners sought review of these deficiences in the Tax Court.

3. In the Tax Court, petitioners conceded that the partnerships' short-term loans were shams and that they were not entitled to deduct that part of the partnership losses attributable to the alleged "interest" expenses. They urged, however, that their cash contributions to the partnerships were deductible as theft losses in 1979 and 1980 (Pet. App. 45-46).

The Tax Court denied the claimed theft loss deductions for several reasons. First, it held that, under Section 165(e) of the Internal Revenue Code, a theft loss may be deducted only in the year that the theft is discovered. Since petitioners did not discover the alleged theft loss during any of the tax years in issue in this case, they were not entitled to a theft loss deduction for those periods (Pet. App. 49-54). Second, the court concluded that "[t]he evidence does not support a holding that Schulman fraudulently appropriated petitioners' money or intended to deprive them of it unlaw-

fully" (*id.* at 55). Since the prospectus, which emphasized tax benefits, did not promise that these benefits would withstand IRS scrutiny, the court concluded that "[p]etitioners received exactly what they bargained for—title to a post office building with no down payment and claims to tax deductions greatly exceeding their cash investment" (*id.* at 56). Finally, the court held that petitioners failed to demonstrate that there was no reasonable prospect that the alleged theft loss would be recovered (*id.* at 60-61).

The Tax Court also denied the deductions for petitioners' proportionate share of the partnership losses on the alternate grounds that the purchases of the post offices lacked economic substance and that the partnerships did not have a profit motive (Pet. App. 61-94). Several factors evidenced that these transactions lacked economic substance: (i) the purchase price of the properties significantly exceeded their fair market values (*id.* at 74-75); (ii) there was no potential for profit in the investment in the post office properties; (iii) the petitioners had no personal liability on the notes; (iv) the lessee had options to purchase the properties at prices significantly lower than the partnerships' indebtedness on them; (v) there was no possibility of a positive cash flow to the partnerships (*id.* at 76-82).

The Tax Court also sustained the Commissioner's determination that petitioners were liable for various penalties under the Internal Revenue Code (Pet. App. 94-102). In sustaining the negligence penalty, the Tax Court rejected petitioners' claims that they were "innocent victims of a fraudulent promoter" (*id.* at 95) and observed that "[e]ven a cursory examination of the partnerships' instruments would have raised grave doubts in the mind of a reasonable, prudent investor as to the promised tax benefits" (*id.* at 97).

4. The court of appeals affirmed. The court upheld the disallowance of the theft loss deductions because such deductions may be claimed only in the year in which

knowledge of the theft occurs (Pet. App. 2). It affirmed the disallowance of the depreciation and interest deductions on the ground that the transactions on which the deductions were based lacked economic substance (*id.* at 2-3). The court of appeals' brief opinion did not expressly discuss the propriety of the penalties that were imposed.

ARGUMENT

The decision of the court of appeals is correct. It does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. The court of appeals correctly concluded that even if an embezzlement of petitioner's investment had occurred,[1] the 1979 and 1980 tax years that are involved in this case were not proper years for such a deduction to be claimed. Under Section 165(e) of the Internal Revenue Code, a theft loss may be deducted only "during the taxable year in which the taxpayer discovers such loss." 26 U.S.C. 165(e). The statute thus makes it clear that "[t]he relevant year is not the year in which a business 'loss' is incurred or reflected on the books of a business, but the year in which a '*theft* loss' is discovered." *Lary* v. *United States*, 608 F. Supp.

---

[1] The Tax Court correctly determined that petitioners had not established that an embezzlement had occurred (Pet. App. 55). Schulman was indicted and convicted of crimes relating to his promotion and administration of abusive tax shelters—conspiracy and making and aiding in the preparation of false tax returns—not of embezzlement (*id.* at 34-35). It is unclear what happened to petitioner's cash contributions. Schulman obtained at least some of the cash generated by the partnership. He received a five percent commission for selling the post offices to the partnerships (Exh. 88-CJ, at 24). Postal Management Services Company, which Schulman controlled, received management fees from the partnerships (Pet. App. 21, 25-26). Furthermore, as general partner, Schulman received a portion of the cash contributions to the partnerships (*id.* at 8, 12).

258, 261 (N.D. Ala. 1985), aff'd, 787 F.2d 1538 (11th Cir. 1986) (emphasis by the court).[2] Treasury regulations therefore specify that "a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss." Treas. Reg. § 1.165-8(a)(2). Since petitioners did not discover the alleged theft loss until several years after the tax years at issue here were concluded (Pet. App. 47), they quite plainly are not entitled to the deduction in this case.

The decision of the court of appeals does not conflict with the court's prior decision in *Rod Warren Ink* v. *Commissioner*, 912 F.2d 325 (9th Cir. 1990), on which petitioners erroneously rely (Pet. 32).[3] Unlike the present case, *Rod Warren Ink* concerned the interplay of the theft loss deduction and the personal holding company tax on undistributed corporate income. The court recognized in *Rod Warren Ink* that, under "the literal meaning of section 165(e)," the year of the discovery of the theft was the appropriate year for the theft loss deduction. 912 F.2d at 327. Because a taxpayer could not carry back a theft loss (or any other loss) to prior tax years for personal holding company tax purposes under Section 545(b)(4) of the Code, however, the court held that, "under the unique factual pattern of this case, a literal application of section 165(e) would unduly penalize the taxpayer." 912 F.2d at 328. The "unique factual pattern" of *Rod Warren Ink* does not exist in this case.

---

[2] Petitioners err in relying (Pet. 29 n.14) on *Rainbow Inn, Inc.* v. *Commissioner*, 433 F.2d 640 (3d Cir. 1970), and *Ramsay Scarlett & Co.* v. *Commissioner*, 61 T.C. 795 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975). Those cases concern the entirely separate question whether a reasonable prospect of recovery existed in the year the theft loss was discovered.

[3] Moreover, an intra-circuit conflict would not warrant Supreme Court review. See Sup. Ct. R. 10.1(a).

2. The Ninth Circuit correctly held that petitioners were not entitled to the depreciation and interest deductions claimed on their returns because the partnership transactions on which those deductions were based lacked economic substance. It is, of course, well settled that taxation turns on the substance, not the form, of a transaction. *Gregory* v. *Helvering*, 293 U.S. 465, 470 (1935). See *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, 266-267 (1958). There was no economic substance to the partnerships' transactions in this case.

It has consistently been held that nonrecourse indebtedness may be treated as genuine indebtedness if, but only if, the fair market value of the property securing the debt is at least equal to the principal amount of the debt. *Polakof* v. *Commissioner*, 820 F.2d 321 (9th Cir. 1987), cert. denied, 484 U.S. 1025 (1988); *Estate of Isaacson* v. *Commissioner*, 860 F.2d 55 (2d Cir. 1988); *Odend'hal* v. *Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985); *Brannen* v. *Commissioner*, 722 F.2d 695 (11th Cir. 1984); *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976).[4] The face amount of the debt far exceeded the fair market value of the property in this case (Pet. App. 74-75). Moreover, the partnerships had no economic incentive to make payments on the notes because the notes were nonrecourse obligations for which

---

[4] In *Pleasant Summit Land Corp.* v. *Commissioner*, 863 F.2d 263 (3d Cir. 1988), cert. denied, 493 U.S. 901 (1989), the court of appeals allowed a deduction for a portion of the interest and depreciation attributable to an investment made with nonrecourse debt even though the indebtedness exceeded the fair market value of the property. The court allowed a partial deduction for interest and depreciation to the extent attributable to the fair market value of the property. Petitioners have never claimed entitlement to a partial deduction, and the issue addressed in *Pleasant Summit* was thus neither presented nor decided in this case.

the limited partners had no personal liability. Even after 25 years of mortgage payments, each partnership's outstanding debt would still be substantially greater than the fair market value of the post offices at the time of their acquisition (*id.* at 22-23, 27-28, 75). The government's options to acquire the post offices at prices substantially lower than the prices paid by the partnerships further indicate that the purported sales lacked economic substance. See *United States* v. *Schulman*, 817 F.2d 1355, 1359 (9th Cir. 1987) ("the financing arrangement has to be evaluated separately on its own merits and cannot be found to have substance merely because the partnerships acquired real property or invested 'real' money"), cert. denied, 111 S. Ct. 51 (1990).

Petitioners err in contending (Pet. 39) that the decision in this case conflicts with *Commissioner* v. *Tufts*, 461 U.S. 300 (1983). The only issue presented in *Tufts* was whether the amount of a nonrecourse mortgage on real property should be included in the computation of the amount realized on the sale of property when the original amount of the mortgage had been included in the property's basis for purposes of depreciation deductions. Because the taxpayer had included the amount of the nonrecourse mortgage in the basis of the property, the Court held that, on the sale, he must include the amount of the mortgage as a proceed of the sale upon the transfer of the property. *Id.* at 313. The Court did not hold that all nonrecourse indebtedness is true indebtedness and did not authorize the inclusion of all nonrecourse indebtedness in the taxpayers' basis for purposes of computing deductions. Indeed, the Court noted in *Tufts* that the Commissioner may, in appropriate cases, properly adopt the position "that a nonrecourse mortgage is not true debt" (*id.* at 308 n.5).

3. Petitioners contend (Pet. 42-45) that additions to tax under Sections 6653(a) and 6661 and additional interest under Section 6621(c) should not have been imposed.

Petitioners cite no decisions in support of their claim and their factual arguments were properly rejected by the court below. Further review of these issues is not warranted.

The addition to tax under Section 6653(a) is imposed when an underpayment results from negligence or from intentional disregard of rules and regulations. See *Neely* v. *Commissioner*, 85 T.C. 934, 947 (1985). The Tax Court quite properly did not credit petitioners' self-serving statement that they believed their investment was genuine. The court observed that "[e]ven a cursory examination of the partnerships' instruments would have raised grave doubts in the mind of a reasonable, prudent investor as to the promised tax benefits" (Pet. App. 97). The court concluded "that petitioners purposefully looked away from the realities of the partnerships' activities" (*ibid.*).

With respect to the addition to tax under Section 6661—which is imposed for a substantial understatement of income when there is no substantial authority to support the taxpayer's treatment of the tax shelter items (26 U.S.C. 6661; Pet. App. 98)—the Tax Court correctly found that there was no authority to support petitioners' deductions (Pet. App. 99-100). The Tax Court also correctly held that Section 6621(c)—which provides an increased rate of interest for tax deficiencies resulting from a substantial underpayment attributable to "tax motivated transactions"—was applicable to petitioners because the partnerships' activities lacked economic substance and were not engaged in for profit.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General
SHIRLEY D. PETERSON
Assistant Attorney General
DAVID ENGLISH CARMACK
JOAN I. OPPENHEIMER
Attorneys

AUGUST 1991

☆ U.S. GOVERNMENT PRINTING OFFICE: 1991—282-061/45022